25X1

Directorate of Intelligence

~~Secret~~

[redacted]

File Copy -- do not remove

5 art
31 briefs

International Economic & Energy Weekly [redacted]

25X1

1 March 1985

~~Secret~~

DI IEEW 85-009
1 March 1985

Copy 683

Page Denied

Declassified in Part - Sanitized Copy Approved for Release 2012/03/02 : CIA-RDP97-00771R000707420001-2

International Economic & Energy Weekly

25X1

1 March 1985

iii	Synopsis	
1	Perspective—West European Restructuring Outlook	25X1 25X1
3	Briefs: Energy; International Finance; Global and Regional Developments; National Developments	
15	West Germany: Cutting Back the Budget Deficit	25X1 25X1
19	Italian Machine Tool Industry: A European Success Story	25X1 25X1
23	The European Fighter Aircraft Program	25X1 25X1
27	New Steel Technologies for the 1990s: Impact on Competitiveness	25X1 25X1
31	Oman: Facing a Guns-or-Butter Dilemma	25X1 25X1
		25X1
	Indicators	

Comments and queries regarding this publication are welcome. They may be directed to *Directorate of Intelligence,* 25X1

25X1

International Economic & Energy Weekly

25X1

Synopsis

---

1 **Perspective—*West European Restructuring Outlook*** 25X1

There has been growing talk in Western Europe—and even some action—concerning ways to reinvigorate their economies through private entrepreneurship and less government intervention. 25X1

---

15 **West Germany: Cutting Back the Budget Deficit** 25X1

Many developed countries have been preaching austerity, but West Germany has been uniquely successful in reducing budgetary red ink. 25X1

---

19 **Italian Machine Tool Industry: A European Success Story** 25X1

Unlike the bulk of West European industry, the Italian machine tool industry has adapted quickly to changes in technology and markets and thus has weathered the worldwide economic downturn better than its European counterparts. 25X1

---

23 **The European Fighter Aircraft Program** 25X1

Senior defense officials from France, the United Kingdom, West Germany, Italy, and Spain will meet in Rome this month to decide the fate of the multibillion-dollar European Fighter Aircraft (EFA) codevelopment program. We believe that some accommodation will be reached as political commitments are too deep to allow the joint venture to fail at this juncture. 25X1

---

27 **New Steel Technologies for the 1990s: Impact on Competitiveness** 25X1

The steel industries in the major industrialized countries are turning to innovative new technologies to reduce costs and increase profitability following a decade of weak demand and low prices that have kept the industry in turmoil. 25X1

---

31 **Oman: Facing a Guns-or-Butter Dilemma** 25X1

Increasingly large defense expenditures are beginning to cause concern within the Omani Government that the country's economic development will suffer, threatening the stability of Sultan Qaboo's regime. Oman will press the United States for additional military aid to purchase F-16s and for more "rent" for the use of facilities by US forces during bilateral talks scheduled for 18-19 May.

25X1

DI IEEW 85-009
1 March 1985

25X1

International Economic & Energy Weekly

25X1

1 March 1985

25X1

Perspective

West European Restructuring Outlook

An important theme at the Bonn Economic Summit in May will be overcoming "economic rigidities," particularly in Western Europe. There has been growing talk in Western Europe—and even some action—concerning ways to reinvigorate their economies through private entrepreneurship and less government intervention. Europessimism—looking at how bad things are in Europe, in terms both of analysis and public opinion—may have peaked and may be in the process of being replaced by growing interest in solutions and positive examples. 25X1

The West Europeans seem to recognize that labor immobility, administrative bottlenecks, and conservative or inadequate financial systems are hindering economic progress. Nonetheless, they will likely claim that the appreciating dollar is making the economic adjustment process more difficult. They will argue that the US budget deficit causes high interest rates, thereby encouraging foreign financing of the US deficit and reducing West European investment. 25X1

We think the West European economies do have some serious and fundamental economic problems:

- West European employment today is about the same as it was 10 years ago. The US economy over the past 10 years has added some 20 million people to the job rolls.

- Largely because of inadequate job creation, Western Europe's unemployment rate—now over 11 percent—has increased in each of the past 13 years and may continue increasing through this decade.

- Over the past four years, the combination of the strong dollar and the rapid US recovery has produced a swing in the US–West European trade balance of $40-50 billion in Europe's favor. This shift is equivalent to about 2 percentage points of West European GNP growth, implying that, absent the trade gains, West European growth could well have remained near zero over the past two years. 25X1

The West Europeans may be starting to realize that there are at least two separate steps involved in successful restructuring and technological development: (1) knowing how to make a product and (2) knowing how—or being allowed—to make it profitably. Seemingly adequate levels of R&D spending have

Declassified in Part - Sanitized Copy Approved for Release 2012/03/02 : CIA-RDP97-00771R000707420001-2

produced meager results, and the frustrating technology gap vis-a-vis the United States and Japan widens. West European companies are buying into high-tech firms to ensure access to new technological developments. Buying in, however, is only the first, and easiest, step—a classic example, the VCR was invented in Western Europe, but the Japanese now dominate the market. [redacted] 25X1

25X1

We believe Western Europe's chances of successfully commercializing new technologies would be improved to the extent governments encourage greater market flexibility. West European governments, however, generally have tried to play it safe by guaranteeing success on the upside and preventing job losses on the downside. European governments clearly are not comfortable with rough-and-tumble capitalism; nor are their voters likely to allow the full range of wage and employment adjustments necessary to become fully competitive. This defensiveness will, in our judgment, continue to put severe limits on West European economic progress and, in addition, will prevent agreement on significant policy initiatives at the Bonn summit. [redacted] 25X1

Briefs

Energy

OPEC January Oil Production

OPEC produced slightly under 16 million b/d of crude oil in January—the lowest monthly average in almost two years—as output fell 800,000 b/d below December levels. Although the organization has finally achieved the 16-million-b/d ceiling on total output agreed upon last October, the production drop was absorbed primarily by Saudi Arabia and Nigeria. To support prices, Riyadh continues to appear willing to accept low levels of output as long as production remains above 3 million b/d. We believe Lagos lowered output before OPEC's January ministerial meeting in part to blunt criticism of its refusal to abide by the group's production and pricing guidelines. Of the other members, however, at least seven are currently producing above their quotas. 25X1

25X1

OPEC: Crude Oil Production *Million b/d*

	1984					1985
	October Quota	Year	Fourth Quarter	November	December	January
Total	**16.00**	**17.7**	**16.6**	**16.4**	**16.6**	**15.8**
Algeria	0.66	0.7	0.7	0.7	0.7	0.7
Ecuador	0.18	0.3	0.3	0.3	0.3	0.2
Gabon	0.14	0.2	0.2	0.2	0.2	0.2
Indonesia	1.19	1.4	1.3	1.3	1.3	1.4
Iran	2.30	2.4	2.1	2.1	2.3	2.1
Iraq	1.20	1.2	1.3	1.3	1.3	1.3
Kuwait	0.90	0.9	0.9	0.8	0.9	0.8
Libya	0.99	1.1	1.0	1.0	1.0	1.0
Neutral Zone	[a]	0.5	0.4	0.4	0.4	0.4
Nigeria	1.30	1.4	1.6	1.5	1.7	1.4
Qatar	0.28	0.4	0.3	0.3	0.3	0.3
Saudi Arabia	4.35	4.4	3.8	3.8	3.5	3.3
United Arab Emirates	0.95	1.2	1.2	1.1	1.2	1.1
Venezuela	1.56	1.7	1.6	1.6	1.6	1.6

[a] Neutral Zone has no production quota; output is divided evenly and added to Saudi and Kuwaiti totals.

25X1

Nuclear Power Boosts EC Electricity Production in 1984

[redacted]

Led by a 28-percent increase in nuclear power generation, net electricity production rose by 4.8 percent in the European Community (EC) in 1984, approximately double the growth rate for the previous year. Average growth in consumption increased by more than 4 percent, boosted by the recovery in some major industries, continued growth in the electricity-intensive service industries, and sustained household demand. The increase in nuclear power continued the European trend away from fossil fuels, displacing the equivalent of about 60,000 b/d of crude oil. For the year, nuclear energy accounted for a record 27 percent of total electricity production, up from the previous record of 21 percent in 1983. We expect nuclear power to continue to lead the growth in EC electricity production in 1985. [redacted]

25X1 25X1

Spanish-Algerian Gas Dispute Ended

[redacted]

Spain and Algeria have settled their liquefied natural gas contract disagreement, according to Embassy reporting. The 1975 contract, in dispute since 1981, called for deliveries of 4.5 billion cubic meters (bcm) of gas per year, although Spain has actually purchased only 1.5 bcm annually. The Spanish national gas company has reportedly agreed to compensate the Algerian state energy company by providing $500 million in goods and services for gas not purchased under the take-or-pay contract terms. In return, Algeria has agreed to lengthen the original contract to 2004 to permit reduced annual purchases of 3.2 bcm per year until 1992 and 3.8 bcm per year thereafter. Algeria has reportedly dropped the take-or-pay provisions and has agreed to a $1 price rise to just under $3.90 per million Btu. Although natural gas now provides less than 3 percent of total Spanish energy consumption, this share is expected to double by 1992. Currently, Spain imports nearly all its gas from Algeria and Libya, but new domestic production is expected to amount to nearly 3 bcm in 10 years. [redacted]

25X1 25X1

Tehran Seeks Canadian Oilfield Equipment

[redacted]

Iran has selected a Canadian company as the prime supplier of new oilfield turbine and compressor equipment as well as spare parts for older—probably US origin—equipment [redacted] Iran is determined not to import any oilfield equipment directly from the United States or France. Much of the equipment purchased from Canada, however, is actually made in the United States and only shipped to Canada for final assembly. [redacted] Iran has a short-term need for a substantial amount of oilfield equipment to replace US-made equipment that is no longer operational. The new equipment purchased from Canada will probably be used for gas injection, and we expect additional purchases of Western equipment to reverse Iran's seriously deteriorating oilfield productive capacity. Besides Canada, Tehran can turn to West European and Japanese suppliers. [redacted]

25X1 25X1 25X1 25X1 25X1

Pakistani Oil Output To Double

Pakistan's oil production will nearly double—to 47,000 to 50,000 b/d—within the next year, according to US Embassy sources in Islamabad. The government's hopes for petroleum self-sufficiency by the end of the decade have been 25X1 greatly improved by progress at the US-developed Dhurnal field near Rawalpindi, which is expected to produce 20,000 to 25,000 b/d by the fall. Pipeline capacity is currently limiting production, but the government and a US oil company are cooperating to rush construction of a new pipeline to a nearby refinery. At a time of deteriorating nonoil trade balance and declining worker remittances, a reduced oil import bill would be most welcome. An additional 20,000 b/d from the Dhurnal field, for example, would save Pakistan about $200 million a year at today's prices. Pakistan will still need to import an average of about 90,000 b/d of petroleum and petroleum products, however, to meet domestic demand. 25X1

Mexican Water Injection Problems

Poor results with water injection projects at several major Mexican oilfields in the Reforma area have prompted Pemex to scale back to a pilot project for water injection at Abkatun field in the Bay of Campeche to begin later this year. By the end of 1984, Pemex had suspended nearly all water injection at 25X1 Reforma because of growing evidence of damage to some of the fields. The Campeche reservoirs are geologically similar to those in Reforma, and preliminary reservoir testing for the effects of water injection at Abkatun has shown disappointing results. We believe that Mexico should instead concentrate its investments in oil exploration to meet future needs. As things now stand, however, austerity and declining world oil prices make it unlikely that the investments needed to sustain any major exploration program will be forthcoming. 25X1

Chad's Oil Exploration Shows Promise

Preliminary estimates from exploratory drilling in southern Chad are promising, and the US company carrying out the project expects to bring in a test 25X1 well in a few weeks. A company spokesman told the US Embassy that the kidnaping of two US employees by Chadian dissidents will not disrupt operations at the drilling site. The hostages were rescued unharmed by Chadian forces on 13 February, after being held for five days. The company says it will consider laying a pipeline to the Cameroonian port of Douala—several hundred miles distant—if sufficient quantities of light oil are found, an increasing possibility. 25X1

International Finance

LDC Bond Issues Increase

Issues of foreign and international bonds by LDCs rose by more than $1 billion in 1984, the first increase since 1981. The largest issuers last year were Malaysia and South Korea, which floated about $2.2 billion of the $3.5 billion 25X1 LDC total. Since the onset of the Latin American debt problems in 1982, the market for LDC bonds generally has been limited to countries with prime credit ratings. Asian countries—considered the most creditworthy LDCs—have taken advantage of their access to bond markets, obtaining better terms

LDC Bond Issues *Million US $*

	1983	1984
Total	**2,470**	**3,538**
Bahrain	0	100
Colombia	15	0
Egypt	40	0
Hong Kong	63	186
India	60	298
Indonesia	366	50
Kuwait	0	50
Malaysia	885	1,141
Panama	21	0
Papua New Guinea	0	21
Saudi Arabia	0	200
Singapore	70	0
South Korea	547	1,056
Taiwan	40	21
Thailand	253	283
Trinidad and Tobago	50	107
Tunisia	60	0
United Arab Emirates	0	25

25X1

than on syndicated loans. We believe that the bond markets will remain a minor source of funds for LDCs as a whole but will be used more widely by the better credit risks particularly if commercial banks remain reluctant to increase syndicated lending. 25X1

Philippine Financial Rescue Package Hits Snag

Signing of the commercial banks' financial rescue package, scheduled for this week, has been postponed indefinitely because a major Saudi bank is refusing to participate. Bankers coordinating the package apparently are concerned that other banks will withdraw if the Saudi bank—still miffed over a 1980 transaction with Philippine banks—does not pledge the $13 million in new financing that its exposure in the Philippines requires. Commercial bank financing—including $925 million in loans—is the third element in a $10 billion rescue package comprising new money, an IMF balance-of-payments loan, and rescheduled official debt payments. Other commercial banks, the IMF, and Manila's large aid donors are pressuring the reluctant bank, and a breakthrough is likely soon. The delayed signing and the feared withdrawal of other banks, however, underscore the fragile nature of the financial rescue package and suggest it could still unravel because of unfavorable political or economic events in Manila. 25X1

25X1

Turkish Credit Concluded [redacted]

The Turkish Central Bank announced last week that prolonged negotiations for a $500 million medium-term commercial loan were concluded. The seven-year loan will have an interest rate of 1.375 percentage points above LIBOR, according to the US Embassy, slightly better than the 1.75-percentage-point spread Turkey received in its March 1984 syndication. Nineteen banks will participate in the credit, with each taking shares of $20-30 million. Arranging the loan proved difficult because of the new type of credit facility being used—lead banks will underwrite successive issues of short-term Euromarket notes—and the increase in the amount of the loan. Last year's credit facility with commercial banks amounted to $300 million. [redacted] 25X1 25X1

Moroccan-US Financial Problems [redacted]

Rabat's inability to service its external debt already has caused the suspension of $250 million in CCC credits and could cost Morocco access to US military assistance by this spring. The government put repayment of official debt on hold in January to conserve dwindling foreign exchange reserves—less than $35 million—until a new debt rescheduling agreement is negotiated. As a result of the loss of CCC credits, Rabat has made overtures to the French to cover the estimated 150,000-ton wheat shortfall expected this month. If Paris does not come through, Morocco may be forced to use remaining reserves to meet grain import needs and forgo resolving arrears on US military purchases. The US Embassy in Rabat estimates that about $17 million in overdue payments is subject to Brooke amendment sanctions this year of which $8 million is due on 30 April. Without a new debt rescheduling agreement or additional food aid, the government will be hard pressed to pay for both essential imports and outstanding bills to Washington and other foreign creditors. [redacted] 25X1 25X1

[redacted] 25X1

Islamic Development Bank Annual Meeting [redacted]

The Islamic Development Bank (IDB) at its annual meeting last month in Dhaka restored Egypt to full membership and released to Cairo $25.5 million in deposits frozen since 1979. Syria and Libya found little support for their opposition to Egypt's readmission. The IDB actions reflect the continued reintegration of Egypt into mainstream Islamic and Arab affairs. Afghanistan is now the only IDB member still under suspension. Turkey received a permanent seat on the Board of Governors alongside Saudi Arabia, Kuwait, 25X1

Libya, and the UAE. The Board approved $123 million in new aid requests, with Pakistan, Bangladesh, North Yemen, and Syria receiving most of the funds. The IDB has been criticized by its poorer members for concentrating on short-term foreign trade financing, but development loans are more difficult to arrange given the Islamic prohibition on interest. [redacted] 25X1

Global and Regional Developments

West European Software Agreement

[redacted] 25X1

The recently announced West European software agreement on operating systems standards will not achieve its desired effect. The major West European manufacturers have chosen a software standard based on the popular Unix operating system developed by AT&T. The often stated purpose of this choice was that it would help reduce IBM's domination of the West European market. Because IBM has supported a common standard for Western Europe and has recently started offering fully supported implementations of Unix System V, European manufacturers are liable to see little change in the status quo. [redacted] 25X1

National Developments

Developed Countries

UK Miners' Strike Eroding

[redacted] 25X1

British coal miners returned to work in record numbers this week, following the collapse last week of another attempt to end the 50-week-old strike. The National Coal Board claims that 49 percent of the 187,000 miners now have abandoned the strike. The government has ruled out further negotiations and is offering strikers a cash bonus of up to $107 if they return by 11 March. In the first break among union officials, the president of the Yorkshire local where the strike began admits that members may have to return to work without a settlement. This return-to-work trend is likely to continue. Prime Minister Thatcher will declare victory when 50 percent of the miners have returned, probably by the anniversary of the strike on 12 March. [redacted] 25X1

French Investment Prospects Brighten

[redacted] 25X1

French investment is likely to increase in 1985, judging from recent government surveys. Although many businessmen complain that profits are still unsatisfactory and overall financial conditions remain difficult, a growing proportion of firms are reporting improved profits. Industrialists, including those in state-owned manufacturing enterprises, say they intend to increase real investment by 5 percent in 1985; as late as last summer, they planned to reduce investment this year. Although this will stimulate demand, the effect on employment in the investing industries may be disappointing because most investment is designed to replace old equipment and to increase productivity rather than to expand capacity. [redacted] 25X1

Declassified in Part - Sanitized Copy Approved for Release 2012/03/02 : CIA-RDP97-00771R000707420001-2

Japan Debates Capital Controls

Concerned about the recent yen depreciation against the dollar, Japanese parlimentarians are privately pressing the Ministry of Finance to restrict capital outflows. Embassy reporting indicates Ministry officials are trying to defuse the pressure, which runs counter to Japan's commitment to capital market liberalization, by soliciting ideas from financial circles on how to spur capital inflows. On the basis of a similar episode in the summer of 1983—when Prime Minister Nakasone called for capital controls—we believe the Finance Ministry will succeed in heading off formal measures. Finance officials are likely, however, once again to request life insurance companies to limit purchases of foreign securities voluntarily. It is not yet clear whether Tokyo will act on recommendations from local bankers that more government-guaranteed bonds be issued overseas.

25X1

25X1

25X1

Less Developed Countries

Status of Mexican Austerity Measures

[redacted]

Mexico City announced further austerity measures last week, probably in an effort to gain IMF approval for its economic program and to allay public concern over the exceptionally high January inflation figure. [redacted] the government will now cut $1.2 billion from the $85 billion budget for this year, largely through cuts in public-sector investment, with the remainder coming from the sale of state-owned companies and decreases in current expenditures and subsidies. We expect political pressures will continue to prevent the de la Madrid administration from fully implementing significant deficit reduction measures. Lack of private-sector interest in purchasing inefficient or loss-plagued state-owned companies will also frustrate government efforts to cut spending. Meanwhile, the Bank of Mexico indicated it plans to reduce the money supply to 11 percent below December's level, suggesting a high level of concern over the 7.4-percent inflation in January. Continuing depreciation of the peso, wage hikes, and further reductions in subsidies, however, will fuel increases in the cost of living. Moreover, failure to cut the budget as planned will also weaken the fight against higher prices. [redacted] 25X1 25X1 25X1 25X1

Mexican Trade Policy Initiatives

[redacted]

[redacted] Mexico is reviewing its trade policy and stance on joining GATT probably are designed to impress US officials. President de la Madrid and Commerce Secretary Hernandez indicated in speeches over the past several weeks that Mexico is willing to review the multilateral trade framework, and emphasized the importance of improving trade relations with the United States. With the drop in oil prices and limited access to international financial markets, Mexico is counting heavily on increased access to US markets to boost foreign exchange earnings this year. The government probably is seeking to ease growing tensions over Mexican protectionist policies that are threatening several crucial bilateral trade agreements. Mexican officials are pressing for a bilateral subsidies pact that would make it more difficult for US producers to initiate countervailing duty suits against Mexican exporters. [redacted] 25X1 25X1 25X1

[redacted] 25X1

Sudan Adopts Economic Reforms

The Nimeiri regime has announced a combination of budgetary, price, and foreign exchange reforms designed to stabilize the economy and induce foreign donors, particularly the United States, to resume suspended financial assistance. Increased customs receipts—nearly half from added oil import duties— 25X1
selected tax increases, and modest budget cuts are expected to reduce the projected $240 million budget deficit. New petroleum pricing measures will increase gasoline prices by more than 60 percent. The government has also instituted foreign exchange reforms, including a 48-percent official devaluation of the Sudanese pound, a new commercial bank rate, and abolition of the licensed private foreign exchange dealer system. The new commercial bank rate may have been set too low to attract private remittances, however, and a parallel black market is likely to develop. Nimeiri probably believes he has now pushed economic reform about as far as he can without provoking political unrest and expects at least a partial resumption of economic support from the United States and other bilateral donors. 25X1

Libyan Water Project Expanded

Tripoli probably will seek bids totaling $3.3 billion in June on the next stage of the Great Manmade River Project 25X1
South Korea's Dong Ah Company, the main contractor for the first stage, has 25X1
had difficulty meeting construction schedules and probably will not participate in the second phase. Other South Korean firms and Japanese companies are competing, however, and may offer price discounts and oil barter arrangements as sweeteners. US companies are at a serious 25X1
disadvantage because of Libyan concern over US sanctions and the less favorable terms offered. Qadhafi has placed considerable personal prestige on the Great Manmade River Project and has met his financial obligations on the project. His refusal to cut back the scheme in the face of persistent low oil revenues probably will intensify domestic opposition to his economic policies, particularly if such spending causes import shortages. 25X1

Mauritania Faces More Austerity

Nouakchott plans to raise cereal prices by up to 30 percent to reduce the budget deficit and promote domestic grain production. Wage hikes of 10 and 5 percent, respectively, for low- and high-income Mauritanians are scheduled to soften the impact on living standards. The regime also may devalue the 25X1
ouguiya and trim spending—issues that have hindered negotiations with the IMF and stalled debt rescheduling efforts. Implementing these measures, however, will be hampered by another year of bleak economic prospects. Receipts from iron ore and fishing—the primary sources of foreign exchange—probably will languish at the 1984 level. As a result, real GDP growth probably will stagnate around the 1-percent yearly average achieved since 1980, frustrating efforts to trim the budget deficit and reduce the current account deficit. The Taya regime will have to rely even more heavily on foreign benefactors. Saudi Arabia recently supplied $30 million in aid, and the recent rapprochement with Morocco and contacts with several Gulf states raise expectations of additional Arab funds. 25X1

Aluminum Company Dispute With Ghana Settled

[redacted]

After a two-year shutdown, Ghana's US-owned Volta Aluminum Company (Valco) resumed production in January at its smelting plant—the largest in Africa. The closure resulted when the populist-oriented Rawlings regime demanded renegotiation of the original 30-year operating agreement in order to increase government revenues. Although Accra settled for less than it originally asked, the new agreement boosts the government's share of Valco's earnings and increases its revenues from hydroelectric power. The settlement probably reflects Valco's considerable economic contribution and Rawlings's commitment to maintaining his economic opening to the West and attracting foreign investment. If production reaches preclosure levels, Ghana should return to the ranks of the top 10 US trading partners in Sub-Saharan Africa. [redacted]

25X1

25X1

Iran Cuts Budget

[redacted]

Last Sunday Iran's Majles (Parliament) approved a $38.7 billion budget for the fiscal year beginning 22 March that cuts spending by 10 percent and raises taxes by 30 percent compared with last year's budget. The Majles wants to boost fiscal responsibility and reduce reliance on oil revenues. The Majles also lowered Prime Minister Musavi's projection of oil revenues from $19.8 billion to $17.5 billion because oil revenues for the current fiscal year are $6.4 billion below the budget target of $19.1 billion. Moreover, there was concern that Musavi's oil income target would require Iran to exceed its OPEC quota, risking a price war. In addition to higher taxes, doubling the price of heating fuel or gasoline is also being considered, although both measures are likely to spur greater domestic unrest. [redacted]

25X1

25X1

Taiwan's Financial Scandal

[redacted]

Ten senior officials of a major Taiwan corporation and its banking subsidiary—possibly including some senior government officials—have been arrested for financial irregularities. The Ministry of Finance suspended the bank's lending activities on 11 February, and depositors have since withdrawn about $425 million. An audit had revealed illegal private loans and inaccurate bookkeeping practices. The case has sent shock waves through Taiwan's business circles, where private loans at high interest rates absorb as much as 40 percent of savings. Other domestic and some foreign banks have pledged assistance to keep the corporation afloat, and the authorities are moving quickly to contain damage to Taiwan's reputation as a profitable investment market. The incident, however, may impede the government's attempts to attract foreign investment and to become more active in international banking. [redacted]

25X1

25X1

Communist

25X1

New CEMA Initiatives

[redacted]

Two recent CEMA initiatives highlight a renewed effort, probably spearheaded by the USSR, to reduce dependence on the West. Two officials of the International Investment Bank (IIB) told the US Embassy that the IIB plans to increase the share of loans for CEMA projects in "transferable rubles" relative to hard currency loans. The proposed Yamburg gas pipeline, for example,

would receive a greater share of ruble financing than the Orenburg pipeline, because CEMA members now have the capability to produce most of the equipment needed. Although the USSR and its East European partners can produce most of the pumping equipment, we believe they will have to rely on the West for most of the 2.8 million metric tons of large-diameter pipe required. [redacted] 25X1

In early February, a high-level CEMA committee on machine building met for the first time to discuss plans for producing world-class equipment through greater cooperation and specialization. Unless its high-level nature gives it greater authority than the existing CEMA commission on machine building, the new committee's efforts probably will be no more successful than those in the past. According to a Soviet economist, of 18 CEMA machine-building sectors studied, only one had achieved world standards between 1970 and 1982, five were approaching world levels, and the remaining 12 had fallen even further behind. [redacted] 25X1

Yugoslavia's Foreign Exchange Control Dispute

[redacted]

Disputes among republics about central controls over foreign exchange have become a major issue. Prime Minister Planinc, in a recent interview, said that the debate over the foreign exchange system is now the most divisive question in the Yugoslav leadership. A recent ruling by the Constitutional Court voided legislation that gave exporting firms the right to retain foreign exchange receipts and requires the government to draft substitute legislation by the end of March. According to US diplomatic reports, officials in Croatia and Slovenia—which earn surpluses of hard currency—are concerned that new legislation will use political criteria to distribute foreign exchange and thereby undermine the export-led economic recovery program. In contrast, [redacted] the poorer republics of Serbia, Montenegro, and Macedonia are the leading proponents of recentralizing authority over foreign exchange. New legislation probably will reflect a compromise, but it is not likely to be worked out in time to meet the deadline. The dispute is likely to fester for months and will aggravate the usual divisions among the regions. [redacted]

25X1 25X1 25X1 25X1

[redacted]

25X1

West Germany: Cutting Back the Budget Deficit

25X1

Many developed countries have been preaching austerity, but West Germany's has been uniquely successful in reducing budgetary red ink. Under Chancellor Kohl, the federal budget deficit is declining both in absolute terms and as a percentage of GNP. Kohl's policies, however, have taken their toll, falling largely on social programs for the disadvantaged. Moreover, economic growth in 1983 and 1984 was depressed by reduced government spending and higher consumption taxes. Although the government's fiscal plans should begin to provide some stimulus to the economy starting in 1986, we believe a major tax overhaul is necessary to reduce the tax systems's high progressivity that discourages savings and capital investments.

Kohl's Approach

Since coming to power in October 1982, the Kohl government has sought to reduce the role of the government in the economy, while stimulating investment and medium-term growth. Rather than instituting sweeping reforms or blanket spending freezes, Kohl adopted an eclectic, gradualist approach and has made exceptions to suit industrial policy and other objectives. The depressed housing, shipbuilding, and steel industries, for example, have benefited from increased subsidies. Bonn was more than eager to increase research and development expenditures, and defense has also been favored. By altering a wide range of taxes slightly and spreading budget reductions over a number of special interest groups, Kohl has attempted to defuse political resistance to austerity.

In pursuing a more balanced budget, Kohl has focused on spending control rather than tax increases. Total spending by all levels of government rose from 39 percent of GNP in 1969 to almost 50 percent in the early 1980s. Concerned by this increase, Kohl hopes to bring the figure back under 45 percent by 1988. Recent tax policy has favored investment over consumption. Although indirect and social security taxes have increased slightly, the ratio of government tax revenue to GNP has remained relatively constant at about 25 percent.

25X1

Kohl has had little alternative to concentrating spending cuts in the social area. The West German budget, like those of many developed countries, is dominated by nondiscretionary spending. Entitlement programs, public employee salaries, and debt service together constitute about 70 percent of total expenditure. Interest payments have grown most rapidly in recent years, although the escalation in debt servicing costs is now beginning to taper off.

25X1

25X1

Kohl, however, is sensitive to charges that the brunt of austerity has fallen on the less affluent. In an attempt at equity, the 1983 budget called for a 5-percent income tax surcharge—in the form of a compulsory, non-interest-bearing loan—to be imposed on those in higher tax brackets. This measure was declared unconstitutional late last year, however, and the proceeds have been refunded. Although the Cabinet decided against a replacement levy, Kohl still hopes to achieve somewhat more balance in his fiscal programs. In the future, for example, the government intends to aid large families through increased tax deductions.

25X1

The Budget Specifics

25X1

The new Christian Democratic/Free Democratic coalition's revised 1983 budget was similar to an earlier draft submitted by Helmut Schmidt, but

West Germany: Federal Government Budgets

	1980	1981	1982	1983	1984 [a]
Expenditure					
Billion deutsche marks	217.5	234.9	246.6	248.3	251.7
Percent growth	6.1	8.0	5.0	0.7	1.4
Revenue					
Billion deutsche marks	189.9	196.9	208.9	216.4	223.3
Percent growth	6.0	3.7	6.1	3.6	3.2
Taxes (*billion deutsche marks*)	177.5	181.9	184.6	191.9	NA
Other [b] (*billion deutsche marks*)	12.4	15.0	24.3	24.5	NA
Net borrowing					
Billion deutsche marks	27.6	38.0	37.7	31.9	28.4
Percent of GNP	1.8	2.5	2.4	1.9	1.6

[a] Figures for 1984 are estimated. All figures are on a finance basis.
[b] Includes Bundesbank profit.

25X1

entitlements were cut further and public salaries were curbed. The budget reduced child-care payments, delayed cost-of-living adjustments on pensions, and increased health care user charges. On the revenue side, the value-added tax was increased by a percentage point, and employee social security contributions were raised. At the same time, tax breaks and interest subsidies were increased for residential and industrial investment.

The 1984 federal budget again hit social spending and postponed salary increases for public employees, with the aim of holding total expenditure growth to 1.5 percent. Unemployment compensation was cut, as were maternity payments. Social security obligations were raised to strengthen the national pension system. Tax credits and depreciation allowances for corporations and small businesses were hiked to stimulate capital spending.

In both 1983 and 1984, the federal budget deficit was smaller than expected. The 1983 budget had projected a slight rise in the deficit to DM 42 billion, but the actual shortfall dropped to DM 32 billion. Likewise, in 1984 the deficit totaled about DM 5 billion less than the gap projected in the budget. The improvements were partly the result of a stronger-than-expected recovery, but government finances also benefited from external developments. The weak deutsche mark inflated import prices and, hence, tariff revenues. In addition, high US interest rates and Bundesbank exchange market intervention resulted in record central bank earnings on its $40 billion in foreign reserves, and these profits are remitted to the Federal Government.

25X1

25X1

Future Prospects

The 1985 federal budget and the Finance Ministry's most recent revision of the Medium-Term Financial Plan indicate that government spending constraints will continue. Bonn's 1985 draft budget, passed by the Bundestag in December, projects

25X1

West Germany: Medium-Term Financial Plan [a]

	1984	1985	1986	1987	1988
Expenditure					
Billion deutsche marks	257.1	260.2	268.0	276.0	284.0
Percent growth		1.2	3.0	3.0	2.9
Revenue					
Billion deutsche marks	223.5	236.3	242.0	252.8	261.6
Percent growth		5.7	2.4	4.5	3.5
Of which					
Taxes (*billion deutsche marks*)	200.1	211.7	218.5	231.3	241.8
Other [b] (*billion deutsche marks*)	23.2	24.2	23.1	21.1	19.4
Net borrowing (*billion deutsche marks*)	33.6	24.0	26.0	23.2	22.4

[a] As of mid-1984.
[b] Includes Bundesbank profit.

25X1

nominal expenditures up only 1.2 percent from the 1984 draft, although actual spending may rise somewhat more. After 1986, federal expenditure growth is to be held at 3 percent per year, less than the expected rise in nominal GNP. In presenting an otherwise tightfisted document, the Finance Ministry emphasized the good news: the budget crisis is past, and reducing the deficit can proceed without major new cuts in the social net or the threat of increased taxes. The Finance Ministry projects a gradual reduction in government borrowing through 1988 despite the added drain of increased EC contributions beginning next January and higher subsidies for agriculture.

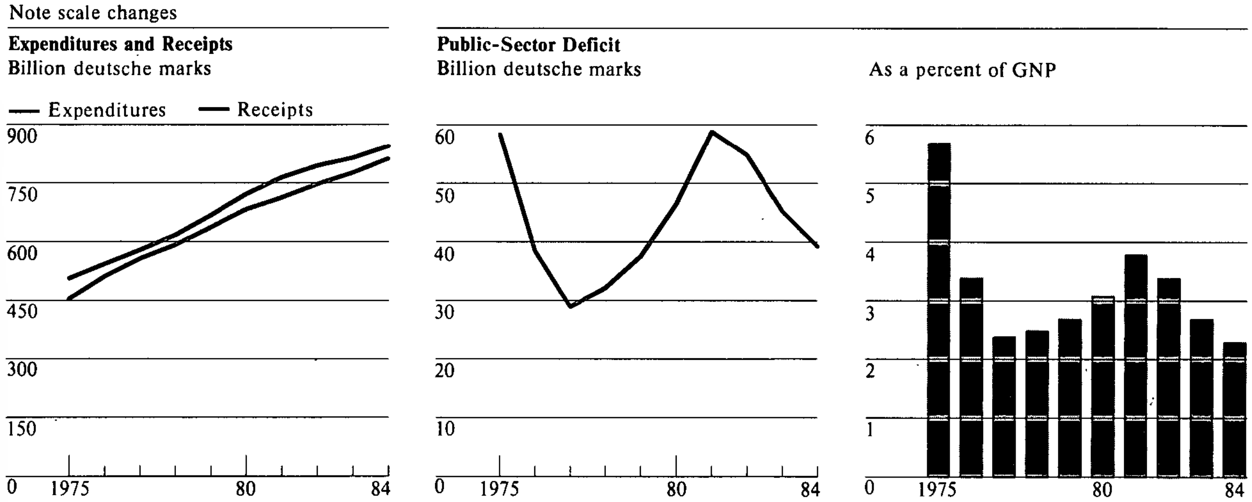
Although federal spending will remain tight, some fiscal stimulus will come from federal tax cuts and from local government spending. Bonn has decided on a two-stage tax reform for 1986 and 1988 to compensate in part for the bracket creep—personal income tax scales were last adjusted in 1981. The first stage will result in tax breaks of about DM 11 billion—roughly 1 percent of disposable income—of which about half is to accrue to families with children. The 1988 tax cuts of about DM 9 billion are designed to reduce the overall progressivity of the income tax system. Fiscal stimulus should also be provided by the regional governments, which are reviving public works projects postponed during austerity. Surveys indicate increased public-sector contracting activity in recent months, which should translate into higher capital expenditures late this year and next. 25X1

Economic Impact

When warning against government indebtedness, the West German Finance Ministry focuses on the national phobia—inflation. The connection between deficit financing and inflation in West Germany, however, is tenuous. Past deficits have been financed primarily by domestic borrowing, not by money creation. The Bundesbank has had no difficulty in achieving its monetary targets in recent years, and monetary expansion in West Germany has not been inflationary. The reduced monetary growth target of 3 to 5 percent for 1985—considered restrictive by some West German economists—will complement tight fiscal policy. The

25X1

West Germany: Public-Sector Finances[a], 1975-84



[a] Federal and regional governments and social security on a national income accounts basis.

[redacted] 25X1

C304908 2-85

Bundesbank implicitly assumes that all significant price pressures have been squeezed out of the economy and that an economic growth path of 2.5 to 3.0 percent is optimal. [redacted] 25X1

On the negative side, Kohl's fiscal policies in 1983 and 1984 have reduced economic growth because government consumption and investment have been depressed. The local authorities, who are responsible for most of the public investment in West Germany, have reacted to federal austerity by cutting capital expenditures. Moreover, higher VAT taxes and reduced transfers have curbed personal consumption. Because of tight budgets the overall performance of domestic demand has been generally disappointing and the West German economy has been forced to rely on exports—buoyed by the strong dollar—for growth. Moreover, the Social Democrats argue that the government's budget policies have worsened unemployment, which stands at about 9 percent. [redacted] 25X1

Although Kohl's tax reforms should provide some fiscal stimulus starting in 1986, a major tax overhaul is necessary to reduce the system's high progressivity to increase incentives for savings and capital investments. The German Council of Economic Advisers in its January 1985 report applauded Kohl's past budget policies, but argued that more aggressive tax action was needed to return the economy to a full employment growth path. Finance Ministry officials have recently advocated revisions to reduce corporate tax burdens and end distorting investment subsidies. Such measures, however, will not be deliberated until the new legislative session begins in spring 1987. [redacted] 25X1

Italian Machine Tool Industry: A European Success Story 25X1

Unlike the bulk of West European industry, the Italian machine tool industry has adapted quickly to changes in technologies and markets and thus has weathered the worldwide economic downturn better than its European counterparts. A stronger performer than many industries in Italy, the machine tool industry has managed to hold market share at home and abroad. Government susidized loans for machine tool users helped turn domestic sales around in 1984, and a recent industry export drive is beginning to pay off, particularly in the US market. The USSR also figures prominently in Italian efforts to boost exports, offering the potential for increased Soviet acquisition of advanced machine tool technology with military applications.

A Tough Competitor

The Italian machine tool industry is a world class competitor, ranking as the world's fifth-largest producer and exporter. Exports have been particularly important to the Italian industry because the domestic market is relatively small. Italy has the second-highest ratio of exports to production among non-Communist producers—57 percent, as compared with Japan's 33 percent.

As in most countries, the Italian machine tool industry is fragmented; it consists of approximately 450 companies averaging 25 employees each. According to an OECD survey, only three firms employ more than 200 workers, and the top 40 companies account for about half of the industry's output. Located in the industrial north, most firms are highly specialized, family-owned operations.

Several factors are responsible for the success of Italian machine tool manufacturers:

- Most of the industry has concentrated on carving out niches in the world machine tool market rather than producing general-purpose machines.
- The small size of most Italian producers has helped these firms maintain relatively low labor and production costs compared with West European and US competitors. A large segment of the industry is not subject to cumbersome government regulations—such as those on employee dismissal—which generally apply only to firms with more than 20 employees. Moreover, smallness has discouraged unionization. 25X1
- The ability of Italian producers to adapt more quickly to new technology than many of their West European counterparts is another plus. Italy was one of the first West European countries to begin using and building numerically controlled (NC) machine tools. 25X1

The Italian Machine Tool Builders Association (UCIMU) has promoted the international competitiveness of the Italian industry. The association offers domestic and overseas marketing services, 25X1 loans for member firms, and funding for a government-sponsored research lab. More than 150 companies are members of the UCIMU, and together they account for about three-fourths of Italy's machine tool production. 25X1

Although in the past little government aid was aimed specifically at the machine tool industry,

25X1

legislation passed in 1982—pushed forcefully by UCIMU—provides subsidized loans for small- and medium-sized firms to finance up to one-third of the cost of new, advanced capital equipment. The program's initial allocation of $53 million was approved at the end of 1983. The Italian manufacturing sector has been quick to request loans to cover retooling of traditional and high technology industries. During the first nine months of 1984, the government approved 1,900 applications valued at $41 million. Largely in response to lobbying by UCIMU, an additional $113 million was allocated to the program in the last half of 1984. 25X1

Recent Trends

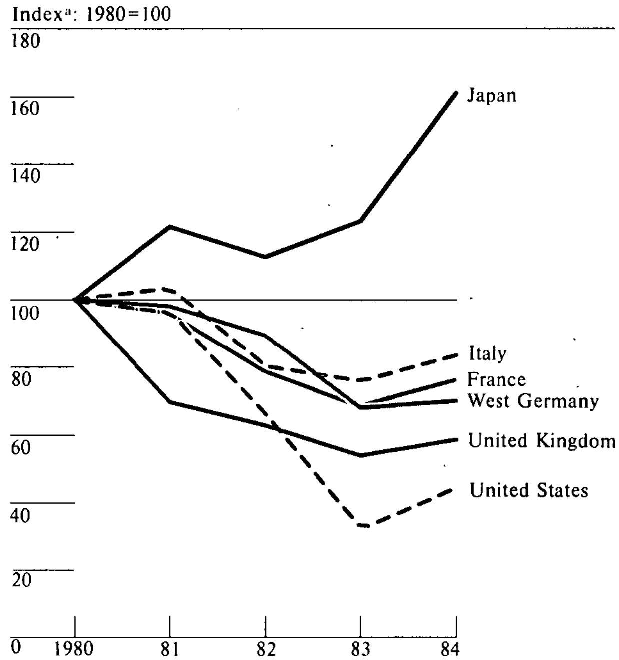
Like other major producers, the Italian industry was affected by the 1981/82 worldwide economic downturn—production dropped 24 percent during 1981-83 period. Domestic sales fell the most because of a steeper recession than in many of its major trading partners. Moreover, debt problems and economic sanctions have hurt sales to Eastern Europe and the USSR. 25X1

The industry, however, fared better than most of its West European counterparts. Italy was able to maintain its share of the world market at about 7 percent while most other West European exporters saw their share of world sales decline. Italy also was able to maintain its large trade surplus in machine tools during the period. 25X1

Although other major producers faced growing import penetration in the early 1980s, particularly from Japan, Italian producers held their own. Italy's strong competitive position coupled with the weak lira kept import penetration relatively constant at about 30 percent, the lowest ratio among major producers except Japan. The Japanese share of the Italian market, for example, remained constant at less than 1 percent. 25X1

With the pickup in the world economy in 1984, the Italian industry is rebounding. Export orders picked up in the fourth quarter of 1983 and domestic orders—helped by government incentives—increased by 60 percent during the first nine months of 1984 compared with the same period in 1983. The industry estimates that 1984 total shipments reached a record high in lira terms, and the decline in export and domestic shipments reversed itself. In real terms output jumped 10 percent in 1984. 25X1

Machine Tool Production, 1980-84



[a] Index based on local currency in real terms.

25X1

304905 2-85

Looking Ahead

We believe that Italian machine tool producers are in a good position to take advantage of the global economic recovery. Moderate wage demands are 25X1

World Market Shares for Major Machine Tool Manufacturers *Percent*

	1980	1981	1982	1983	1984
West Germany	25	23	24	23	22
Japan	13	16	14	15	19
Switzerland	8	7	8	8	7
Italy	8	7	7	7	7
United States	7	9	6	5	4
United Kingdom	6	5	5	4	4
France	5	4	3	4	3

[redacted]

Italy: Machine Tool Trade *Million US $*

	Exports	Imports	Balance
1975	432	213	219
1976	359	160	199
1977	442	193	249
1978	596	195	401
1979	689	256	433
1980	848	356	492
1981	795	300	495
1982	640	209	431
1983	593	182	411
1984 [a]	580	194	386

[a] Estimated.

[redacted]

25X1

25X1

helping to keep the industry competitive. Aided by the weak lira, the Italian machine tool industry is placing increased emphasis on exports particularly to the United States, the USSR, and the LDCs. [redacted]

25X1

To strengthen Italy's position in the US market, UCIMU opened an office in the United States in 1981 and restructured the dealer network and service centers. An increasing number of Italian machine tool manufacturers are establishing sales subsidiaries, and others are linking with US firms to gain marketing and service capabilities. Italy has supplied only about 4 percent of US machine tool imports in the past. [redacted]

Italy is also hopeful of boosting exports elsewhere. UCIMU, for example, is bullish on sales to the USSR—Italy's second-largest market. In addition, UCIMU, in conjunction with the Foreign Trade Ministry and Italy's foreign trade institute is drawing up a three-year program aimed at improving exports to Third World markets, especially India, Egypt, Mexico, and South America. [redacted]

Implications for the United States

We believe the push by Italian machine tool builders to expand exports will adversely affect US domestic and foreign markets and may undermine US efforts to contain the flow of advanced technology to the Soviet Union. Italian efforts to increase US market share comes at a time when US firms are already losing ground to overseas suppliers, primarily the Japanese. Italian exports to the United States are further enhanced by Italian ties with US firms, which can thereby expand their product line while avoiding head to head competition in areas where Italy's machine builders are particularly strong. Such connections sometimes benefit the US industry when they move beyond marketing to include production; several leading Italian exporters have transferred final assembly to their US partners. Outside the US market, the Italian export push is in direct competition with US machine tool manufacturers. Many of the markets most sought by Italian manufacturers—such as Mexico, the largest US export market—have long been US preserves. [redacted]

25X1

25X1

25X1

Italy: Machine Tool Exports by Destination, 1983

Million US $

	Value	Percent of Total
Total	**593**	**100**
Developed	363	61
United States	38	6
Western Europe	276	47
France	91	15
West Germany	53	9
United Kingdom	18	3
Switzerland	14	2
Belgium and Luxembourg	11	2
Spain	11	2
Sweden	9	2
Other	69	12
Eastern Europe	21	4
Romania	9	2
Poland	4	1
USSR	64	11
Others	146	25

25X1

Italy's targeting of the USSR for machine tool sales increases opportunities for Soviet acquisition of advanced machine tool technology. Sales prospects to the USSR appear good based on the Italian-Soviet gas accord, which promises to offset gas sales with purchases of Italian goods. The Soviets are anxious to acquire the type of complete automated systems the Italians can provide. Mandelli, for example, which recently supplied a flexible manufacturing system to Aerospatiale's Toulouse plant, is setting up a subsidiary specifically to sell such systems to the Bloc. According to Embassy and press reporting, the Soviets indicate that they may buy up to $1.8 billion worth of plant and equipment from Fiat by 1990. 25X1

Although such sales do not necessarily include embargoed technology, they will, nevertheless, provide Moscow with highly sophisticated technology with military applications. Flexible manufacturing systems, for example, enable Soviet plants to produce a variety of more reliable parts for military equipment and make possible quick changeover from civil to military production. 25X1

The European Fighter Aircraft Program [redacted]

25X1

Senior defense officials from France, United Kingdom, West Germany, Italy, and Spain will meet in Rome this month to decide the fate of the multibillion-dollar European Fighter Aircraft (EFA) codevelopment program. Earlier sessions have set the stage for a showdown between French and British factions over program leadership and engine selection. We believe that some accommodation will be reached as political commitments are too deep to allow the joint venture to fail at this juncture. EFA is important to the continued viability of Western Europe's military aircraft industry and aerospace employment rolls in the 1990s. Despite insistence on an "all European" product, close relationships between European and US defense firms will likely provide opportunities for US involvement. [redacted]

Motives for the Program

The European Fighter Aircraft is intended to replace aging inventories of US-, French-, and British-made fighters. The five national partners anticipate procurement of 800 aircraft for their own forces and significant exports to the Third World. [redacted]

The Europeans cite a number of political and economic reasons for embracing EFA. On the political front, the project would allow member governments to claim an important contribution to NATO solidarity and defense cooperation. It also would dispel the European industry's image as a mere assembler of US weapons systems and provide a freer hand for export sales. Moreover, concern over US dominance in advanced weapons development is helping to unify government and industry support for increased intra-European defense cooperation. Britain's chief military science adviser recently stated, for example, that the United States is too large to be a viable partner. [redacted]

[redacted]

25X1

On economic grounds, EFA participants see the program as a way to spread costs and risks. They also believe EFA will protect domestic employment and increase the technical proficiency of European aerospace firms. With production runs ending for all current European fighters, the absence of new fighter programs could mean a disbanding of design teams and layoffs of assembly line workers. The impact of lower production levels is already being felt:

25X1

- In early 1984, France's Aerospatiale announced that it was reducing production of sub-assemblies for F-1 and Jaguar fighters.
- West Germany's Messerschmitt-Boelkow-Blohm recently indicated that its 40,000-man work force will be cut 10 percent over the next four years as the Tornado program winds down.
- Dornier also is reducing its work force as West German participation in the Alpha Jet—light trainer, attack—program comes to a close. 25X1

[redacted]

25X1

Status

US attache reports and the press indicate that a preliminary consensus has been reached on the mission and design of the EFA. In addition, operational capability has been targeted for 1995, and initial production orders have been set—200 to 250 each for the United Kingdom, France, West Germany; 100 to 200 for Italy, and 100 to 150 for Spain. Despite agreement on the basic

25X1

Principal European Fighter Aircraft Participants

	Airframes	Engines	Avionics
West Germany	Messerschmitt, Boelkow, and Blohm; Dornier	Motorinen und TurBonen Union (MTU)	Siemens, Rhode und Schwarz, AEG, Telefunken
France	Dassault	SNECMA	Thomson-CSF, Matra
United Kingdom	British Aerospace	Rolls-Royce	Marconi, Plessey, Ferranti
Italy	Aeritalia	Fiat	
Spain	Casa		

[redacted] 25X1

design features and the strong political motivation for EFA, a number of critical hurdles remain. [redacted] 25X1

Program Leadership. Selection of a program leader is central to settling related problems of final design, work distribution, and funding. Both the United Kingdom and France are vying for this role, and their positions reportedly remain far apart. British Aerospace and Dassault-Breguet both claim superior expertise in airframe manufacturing technology. The French are demanding a dominant role in the program (40 percent) based on Dassault's acknowledged leadership within Europe as a builder and exporter of fighters. [redacted] British Aerospace believes its experience in managing the three-nation Panavia consortium (United Kingdom, West Germany, and Italy) qualifies them to spearhead EFA. A Panavia-type arrangement, however, is strongly opposed by the other participants, especially the West Germans. [redacted] 25X1

On the basis of the positive outcome of the last ministerial meeting and recent country official comments, we are convinced that a balanced work distribution can be worked out at this month's meeting. US Embassy reports indicate that the production share arrangement agreed to last July, giving equal shares to the United Kingdom, France, and West Germany will help settle the problem. Observers suggest that French direction of the airframe group and British lead on the engine and some components could be one way out of the leadership dilemma. [redacted] 25X1

Engine Selection. Four main engine candidates are being considered by the consortium. All could deliver adequate thrust; they differ only in levels of technology. According to open sources, the UK–West German RB199 engine—currently used in the Tornado— incorporates technology of the late 1960s. The General Electric F404 powerplant, used in the F18, and France's SNECMA-developed M88 engine are based on mid-1970's technology. SNECMA claims that improvements to its M88 engine will make it competitive with engines to be offered in the 1990s. Officials of Rolls-Royce state that their experimental XG40 engine incorporates current technical achievements, including advanced materials, and is scheduled for demonstrator testing next year. [redacted] 25X1

We believe that the British and French could reach a compromise on engine selection, possibly by electing to form a separate EFA propulsion

European Supersonic Aircraft Production

	Final Year of Production [a]
France	
Mirage III/5/50	1984
Mirage F1	1985
Super Etendard	1983
Mirage 2000	1990
Panavia (United Kingdom, Italy, West Germany)	
Tornado	1989
United Kingdom	
Jaguar	1985

[a] Projected. European Fighter Aircraft production scheduled to begin in 1993-95.

consortium that would marry the technical advances from both the M88 and XG40 engines. The EFA requires some 15-percent weight reduction by any of the proposed engines to meet performance requirements—a highly ambitious goal. A likely joint production scenario would include Rolls-Royce, SNECMA, West Germany's MTU, and Fiat.

Other Problems. The sheer size of the program will complicate the design and production process. EFA currently involves six airframe manufacturers, four engine producers, and a host of electronics and components firms. Overseeing industry are the five defense and finance ministries, in addition to the national air forces of each country. Conflicts are likely to grow as the program matures.

Within the United Kingdom, the British Ministry of Defense is pushing for an upgraded RB199 engine to power the EFA, in part because it would use this powerplant to reengine the Tornado. 25X1

Another source of friction is the disparate arms export policies of the member nations. Attache reports show that Dassault officials are insisting that France receive a large proportion of any export revenues arising from the EFA program because of their experience in managing export sales. In contrast to the French, West Germany's arms export policy is quite restrictive. Within the Panavia consortium, for example, Bonn has maintained the right to veto Tornado aircraft sales to "areas of tension." 25X1

25X1

A Role for the United States?

European leaders fear that job and technology gains would be limited by US participation in EFA. Consequently, the option of buying or coproducing an advanced US fighter was killed at the last ministerial meeting, even though there was near unanimous agreement that the EFA 25X1 would be more costly and not as technologically sophisticated. the 25X1 Europeans believe that such benefits are outweighed by stringent US technology transfer and 25X1 export restrictions, as well as the perceived stigma attached to buying a US aircraft. 25X1

Even with the goal of an all European-produced fighter, there should be at least limited opportunities for US manufacturers. Given the close relationships of many US defense firms with their European counterparts, there is likely to be some US role in the EFA project, especially at the subcontractor and vendor levels. For example, an Italian electronics company expected to be a

25X1

25X1

major subcontractor on EFA is majority owned by a large US defense contractor. Access by US firms should increase once the EFA program gets under way but is unlikely to include any major US components that could control export sales.

25X1

Declassified in Part - Sanitized Copy Approved for Release 2012/03/02 : CIA-RDP97-00771R000707420001-2

New Steel Technologies for the 1990s: Impact on Competitiveness [redacted] 25X1

The steel industries in the major industrialized countries are turning to innovative new technologies to reduce costs and increase profitability following a decade of weak demand and low prices that have kept the industry in turmoil. These technologies, which will gradually transform the way steel is made in the 1990s, will be both risky and initially costly to bring on line. We believe that Japan will be in the best position to lead in the application of the new technologies, but Japanese leadership is not certain. Both West European and US industries have an opportunity to improve their competitive position if they aggressively move to implement the new processes. [redacted] 25X1

Steel Technologies for the 1990s

Two of the most promising new technologies—near-net-shape casting and direct iron smelting—will lead to smaller steel mills that cost about one-third less to build and up to one-fifth less to operate than today's mills. Near-net-shape casting—the direct casting of liquid steel into a shape close to that of the finished item—drastically reduces energy and rolling requirements. In addition to the lower costs, some experts also believe direct casting will lead to quality improvement. [redacted] 25X1

Direct iron smelting will eliminate blast furnaces and coking and sintering plants currently used in smelting iron ore. These new systems gasify ordinary coal to create the chemical agent needed to reduce iron ore to iron and generate the heat necessary to smelt reduced iron to hot metal. Savings stem from: the use of ordinary rather than metallurgical coal; the elimination of coke making; and lower capital costs. [redacted] 25X1

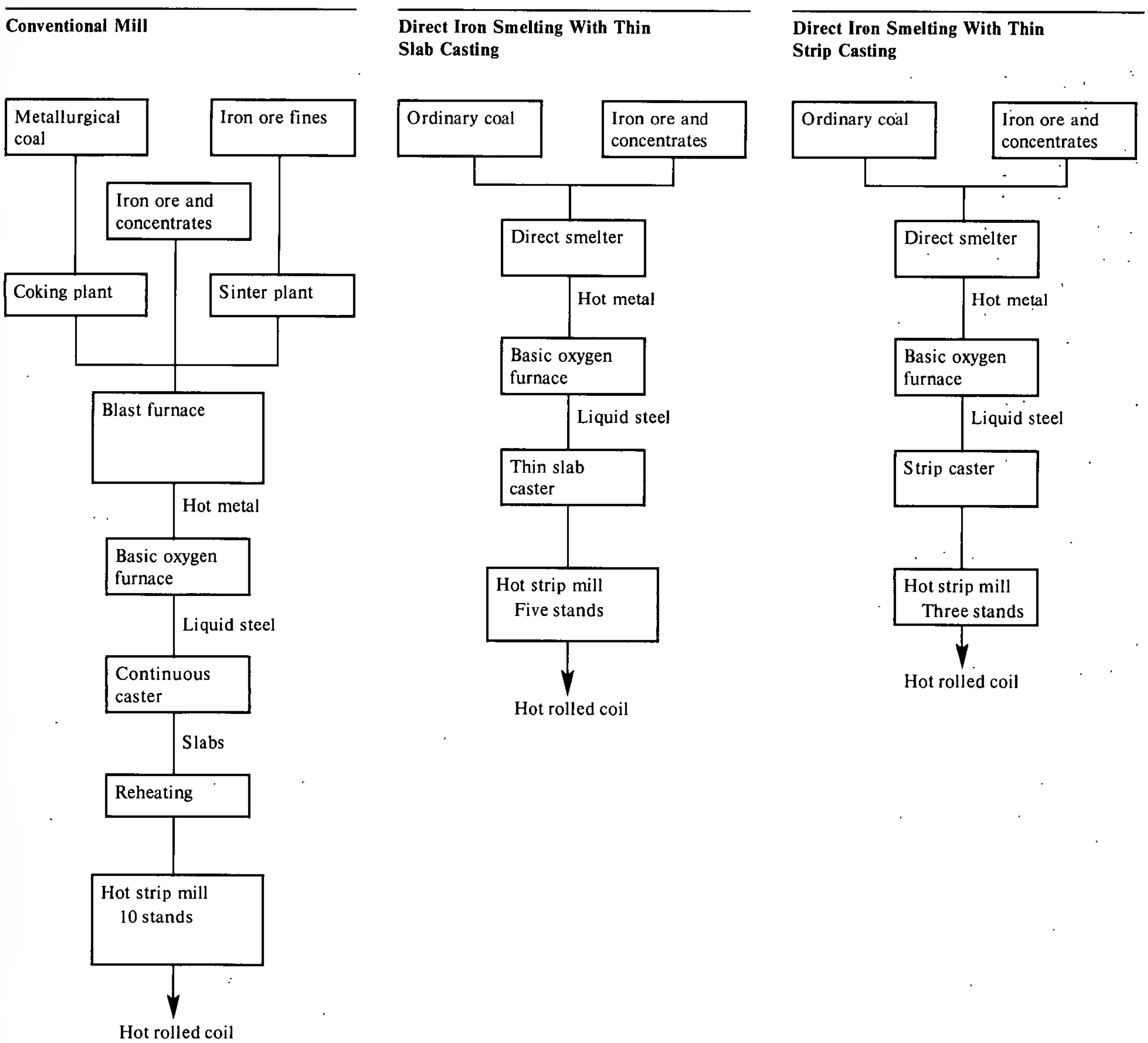
Key Players and Programs

In near-net-shape casting, research is being vigorously pursued in Western Europe, Japan, and the United States. [redacted] 25X1 we believe that the Japanese are devoting more manpower and money to this technology than any of their major rivals. All of the major Japanese steel companies and several large equipment manufacturers are involved [redacted] 25X1 25X1

Despite all this activity, the Japanese are taking a fairly conservative approach and are putting most of their effort into the development of a thin slab casting system, the least radical attempt at near-net-shape casting. Nevertheless, slabs cast in 1- to 2-inch thickness, compared with today's 6- to 12-inch slabs, would save substantial amounts of energy and rolling. Sumitomo Metal appears to have the largest pilot plant and is casting thin slabs in batches up to 40 metric tons. Nippon Steel and Kawasaki Steel are also casting thin slabs experimentally, but on a much smaller scale. Quality is reported to be good enough for the basic steel 25X1

25X1

Alternate Iron Smelting, Steel Casting, and Hot Rolling in Flat Rolled Integrated Mills



25X1

304906 3-85

grades used in construction and some container applications such as drums. Many industry experts believe that one or more of these companies will have a commercial-scale thin slab caster ready within three to five years.

In Europe, the Swiss firm Concast, the oldest builder of continuous steel casting equipment, told US Embassy officials that it has developed a thin slab process and is ready to build a pilot plant. In addition, industry observers report that Mannesmann-Demag in West Germany is doing work generally comparable with Concast. Work is under way at other European firms, such as Danieli in Italy and British Steel, but reportedly is not as far advanced.

Research in the United States has taken a bolder approach to near-net-shape casting; most efforts are aimed at the direct casting of a product roughly equivalent to hot rolled strip, the primary flat rolled product. Allegheny Ludlum recently demonstrated an ability to cast a thin stainless steel strip, an achievement that appears to give the United States a clear lead in the development of this technology. Despite Allegheny Ludlum's success, however, many engineering problems remain in extending this process to high-volume carbon steel production, and most industry experts feel that the commercial application is at least 10 years away.

We believe that West European firms currently lead in direct iron smelting technology, but two Japanese steel companies, Kawasaki and Sumitomo Metal, are also working on the process. Industry observers agree that the leading direct smelting process appears to be the KR system developed in West Germany by Korf Engineering. Korf operates a pilot KR plant in Kehl, West Germany, and current negotiations indicate that it is on the verge of its first commercial sale. Several companies are working on modifications of the KR process. The chief effort is Dutch steelmaker Hoogovens's attempt to adapt the KR system to fit into the shell of an old blast furnace, thus achieving significant cost savings. In addition, three less promising direct smelting processes are under development in Sweden. 25X1

Application: Who Will Lead?

Although no clear technological leader has emerged, we believe that the Japanese will be in the best position to commercialize these technologies. 25X1 For more than two decades, Japanese steelmakers have been the most willing to take risks in bringing commercially untried processes into production, and the Japanese are also in the best financial position to afford the new technologies. 25X1

At the other extreme, the US steel industry is in very poor financial shape and has been among the most cautious in introducing new technology. This pattern, however, may be changing as excess capacity is scrapped and a better supply-demand balance 25X1 gradually develops. In addition, US steel producers have developed a keener interest in new processes that cut costs and improve profitability. A major US minimill operator, for example, recently announced negotiations looking toward cooperation with one or more foreign companies to develop a thin slab casting system for its mills. 25X1

Outlook

We believe the new processes provide steelmakers—particularly those with the oldest facilities—with relatively low-cost ways of improving 25X1 productivity and financial performance. Industry experts indicate that near-net-shape casting technologies, for example, offer higher returns on investment than the steel industry has realized for many years. Direct iron smelting will also provide large savings in operating costs and will cut replacement costs for aging, inefficient blast furnaces and coking plants, particularly in the United States and Europe. 25X1

A major steel industry restructuring is likely to be spawned by the new technologies. Near-net-shape casting, in particular, will spur development of the minimill sector. Direct casting will make it possible for minimills to enter the production of flat rolled

steel on a major scale, something not currently possible because of the large rolling mills required by today's steel technology. In addition, the new technologies will help financially strapped Third World steel producers to cut steel mill construction costs and carry on expansion programs. [redacted] 25X1

Those industries and companies that move most aggressively are likely to enhance their competitive position in world markets. In the case of the United States, the shift toward efficient, low-cost minimill steelmaking probably will go further than in other countries because the difference between scrap prices and hot metal costs—which accounts for most of the minimill's competitive advantage—is wider in the United States than it is abroad. Because the new technologies probably will be widely available, the gain in competitiveness achieved by any one company or country may be small. [redacted] 25X1

Oman: Facing a Guns-or-Butter Dilemma 25X1

Increasingly large defense expenditures are beginning to cause concern within the Omani Government that the country's economic development will suffer, threatening the stability of Sultan Qaboos's regime. Muscat has thus far managed to shield the population from the effects of falling oil prices by expanding production. Oman will press the United States for additional military aid to purchase F-16s and for more "rent" for the use of facilities by US forces during bilateral talks scheduled for 18-19 May. Muscat wants the funds because of its tight financial situation and because some Omani officials expect more tangible evidence of the United States' appreciation for Omani military cooperation.

Declining Current Account Surplus

The doubling of worker remittance outflows and stagnant oil revenues have reduced Oman's current account surplus from its 1981 peak of $1.3 billion to an estimated $500 million last year. Foreign exchange reserves have held fairly steady, largely because of growing financial assistance from abroad. This aid helps pay for the imports required for the heavy defense buildup and economic development program that bolster Sultan Qaboos's regime.

A flood of foreign workers has provided the manpower for Oman's military and economic projects. The US Embassy estimates Oman's expatriate labor force at 270,000—a 70-percent increase since 1981. In October 1983, Muscat implemented new laws to restrict the inflow of foreign workers into Oman, but continuing manpower requirements and the lack of local skilled labor have resulted in lax enforcement. 25X1

Oman, which is not an OPEC member, relies on oil for virtually all of its export earnings and has compensated for the decline in oil prices by boosting production levels. These gains—from 282,000 b/d in 1980 to 410,000 b/d in 1984—were due in large part to Oman's location outside the Persian Gulf war zone. As a result, Oman's oil revenues last year were only $100 million below the 1981 peak of $4.4 billion. Muscat intends to continue expanding production, despite OPEC objections, and has set a production target of at least 500,000 b/d by the end of the decade. 25X1

Despite fairly stable oil revenues, Oman has become increasingly dependent on foreign assistance. 25X1 The Gulf Cooperation Council (GCC) granted Oman $1.8 billion in 1983 to be allocated over 12 years to strengthen its military capability. Saudi Arabia and Kuwait have paid their entire 1984 allotment, but Qatar and the UAE fell behind on their 1984 payments. In addition, the United States provided Oman with $40 million in credits under the Foreign Military Sales (FMS) program in FY 1984 and has budgeted another $45 million for FY 1985. Muscat also received $15 million in loans from the United States in FY 1984 under the Economic Support Fund (ESF) program and $20 million is budgeted for this year. Oman also has received concessionary loans from several Arab 25X1 development funds and from the United Kingdom and West Germany for military construction projects. 25X1

Oman: Balance of Payments *Million US $*

	1980	1981	1982	1983	1984 [a]	1985 [b]
Current account	1,290	1,327	686	408	500	200
Trade balance	1,683	1,973	1,276	1,265	1,500	1,300
Exports (f.o.b.)	3,748	4,696	4,423	4,254	4,500	4,400
Oil	3,603	4,419	4,081	3,899	4,325	4,200
Imports (f.o.b.)	2,065	2,722	3,147	2,989	3,000	−3,100
Services balance	−393	−647	−590	−857	−1,000	−1,100
Worker remittances (net)	−325	−448	−684	−793	−900	−1,000
Government grants	101	148	42	151	150	150
Government loans (net)	14	146	121	387	400	450
Direct investment	117	96	133	194	150	150
Other	−959	−1,530	−1,146	−1,230	−1,037	−875
Errors and omissions	−398	−23	293	−20	−25	
Change in reserves	**166**	**163**	**128**	**−110**	**138**	**−75**

[a] Estimated.
[b] Projected.

[redacted] 25X1

The Defense Buildup

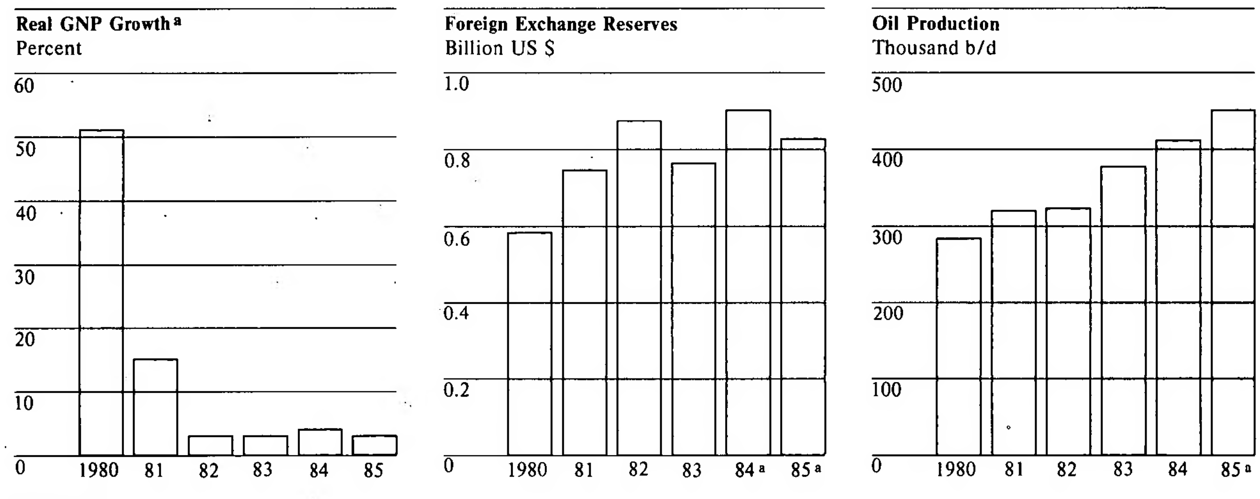
Omani officials view Iran as their country's most immediate national security threat. Oman considers itself the guardian of the Strait of Hormuz and worries about Iranian military and subversive threats. Despite the establishment of diplomatic relations between Muscat and Aden in October 1984, Sultan Qaboos also believes South Yemen still poses a serious security threat. In addition, Oman, which is avowedly anti-Communist, remains wary of the Soviet presence around the Arabian Peninsula. [redacted]

Muscat's ambitious military procurement program has produced defense outlays that, as a share of the budget, are higher than those of any other Gulf country. Defense and security expenditures absorbed 61 percent of oil revenues in 1984, up from 46 percent in 1981. Although oil revenues have fallen below the levels assumed when the current five-year plan (1981-85) was drawn up, military spending has outstripped the plan's projections. [redacted] 25X1

Concern is growing within the Omani Government over the level of spending being siphoned from economic development to defense. Although there is little evidence of increased public disgruntlement, several government officials have called for a cut in defense expenditures—back to 35 percent of the budget, according to US Embassy reports. [redacted] 25X1

To date Qaboos has shown no interest in trimming military outlays and, indeed, is moving forward with plans to procure additional, highly advanced, 25X1

Oman: Economic Indicators, 1980-85



[a] Estimated.

[redacted] 25X1

304907 2-85

equipment [redacted] 25X1 —at an estimated total cost of $350 million and either eight or 12 British Tornado aircraft at a per-unit cost of about $40 million. The financing of these purchases has not yet been worked out. Although the F-16s are less expensive and better suited to Oman's military needs, the Sultan, a strong Anglophile, seems determined to buy at least some new British aircraft. [redacted]

Economic Development: Taking a Backseat

Over the past decade, Qaboos's economic development programs have modernized Oman, but many Omanis have now become dependent on the government for subsidized basic commodities, interest-free business loans, land, and jobs. Although Oman has achieved high rates of GNP growth, broader social welfare indexes reveal that Oman is still underdeveloped. Almost two-thirds of the labor force, for example, still works in subsistence agriculture, life expectancy and literacy rates are low, and the infant mortality rate is among the highest in the world. Moreover, health, education, housing, and sanitation conditions are generally worse in the villages than in the cities, prompting migration to the cities and aggravating urban unemployment and crowding [redacted] 25X1 25X1

Qaboos has recognized the need for a more broad-based economy. Muscat has earmarked funds for the development of infrastructure and social services in remote regions to stem the migration to urban areas. Because present oil reserves are sufficient for only about 25 years, Muscat has emphasized the development of light industry, minerals,

Oman: Government Budgets,[a] 1980-84 *Million US $*

	1980	1981	1982	1983	1984
Government revenues	2,776	3,799	3,446	3,777	3,691
Government expenditures	2,678	3,400	3,950	4,309	4,844
Defense and national security	1,178	1,511	1,683	1,942	1,960
Civil	1,500	1,888	2,267	2,367	2,884
Agriculture and fisheries	42	57	64	65	129
PDO, other oil and minerals	294	373	428	331	360
Roads	130	192	116	122	135
Electricity and water	160	194	262	299	305
Education and youth affairs	269	157	220	278	323
Health	67	91	106	131	188
Other civilian	538	826	1,071	1,140	1,444
Balance	**98**	**399**	**−505**	**−532**	**−1,152**

[a] Fiscal Year began on 1 July of the year stated..

[redacted]

agriculture, fisheries, and services. Faced with a budget deficit nearing $1 billion—roughly equivalent to 15 percent of GDP—however, some of the funds allocated for these projects have been shifted to defense. [redacted] 25X1

Outlook

Oman's economic problems are manageable as long as current revenue levels are maintained. Several factors, however, could make it increasingly difficult to finance both development programs and military procurement while shielding the population from any hardships. These include:

- An escalation of the Iran-Iraq war into the Gulf or a border clash with South Yemen that would require even larger military outlays.
- A sharp drop in the price of oil.
- A cut in grants from Saudi Arabia or other GCC states that would force Muscat to reduce imports.
- A decline in the strength of the dollar to which the Omani riyal is pegged, which would boost the price of imports, especially those from the United Kingdom—Oman's largest trading partner. [redacted] 25X1

Even in the absence of these factors, Muscat will look to Washington for greater military aid to help alleviate Oman's tight budget and to free up funds for economic development. [redacted] 25X1 including limited pre-positioning of military supplies. Qaboos will probably push for increased rent—perhaps to between $50 million and $100 million– [redacted] 25X1 Muscat also hopes to see US appreciation for Omani cooperation under the Access Agreement reflected in administration support for increased FMS credits [redacted] 225X1 and, rather than do without, will probably turn to the British or another supplier willing to offer attractive terms. [redacted] 25X1

Page Denied